ACCOUNTING ASPECTS OF FEDERAL INCORPORATION

BY
ROBERT IRVINE DICKEY
B.S., Wesleyan University, 1930
M.S., University of Illinois, 1939

AN ABSTRACT OF A THESIS
SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN
ACCOUNTANCY IN THE GRADUATE SCHOOL
OF THE UNIVERSITY OF ILLINOIS, 1942

URBANA, ILLINOIS
1942

ACCOUNTING ASPECTS OF FEDERAL INCORPORATION

BY
ROBERT IRVINE DICKEY
B.S., Wesleyan University, 1930
M.S., University of Illinois, 1939

AN ABSTRACT OF A THESIS
SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN
ACCOUNTANCY IN THE GRADUATE SCHOOL
OF THE UNIVERSITY OF ILLINOIS, 1942

URBANA, ILLINOIS
1942

ACKNOWLEDGMENT

Grateful acknowledgment is made to Professor A. C. Littleton for his patient and helpful guidance in supervising this study and to the members of the Accountancy Seminar of the University of Illinois for their friendly criticisms and suggestions.

ACCOUNTING ASPECTS OF FEDERAL INCORPORATION

During the past century the growth in importance of the corporate form of enterprise has been one of the outstanding developments in business. Not only has the percentage of the nation's total business performed by corporations increased but the size and power of the individual companies have grown greatly. Many corporations are no longer small local enterprises under the control of directors who themselves own the greater part of the company's stock or who are closely associated with the owners. Instead, a substantial part of the nation's business is carried on by large corporations which have plants, offices, employees, and customers in many states. These companies are under the control of directors who supplied little if any of the corporation's capital and who are only theoretically the representatives of the real owners of the business. Since these corporations are created by the state governments, yet operate in an area assigned by the Constitution of the United States to the federal government, one solution to the problems presented by the changed status or corporations has been federal incorporation and federal licensing. During the past half century a host of bills with this purpose were introduced in Congress. An analysis of the accounting provisions of these bills against the background of the times in which they were advanced furnishes an interesting study, but indicates that none of the bills employed accounting to its full power in furthering the purposes of federal incorporation.

Not only is it necessary to weigh the advantages of a greater degree of control by the federal government at the expense of the states but also to consider the relative advantages of four closely related alternatives—voluntary federal licensing, voluntary federal incorporation, compulsory federal licensing, and compulsory federal incorporation. The advantages of compulsory federal incorporation over the present system of state incorporation and over the other three alternatives may be summarized very briefly as follows:

1. The corporate form of organization has certain inherent characteristics, such as limited liability of stockholders, which puts upon the government the responsibility of regulating corporations in the public interest. The competition among the states for corporate fees has made it difficult for the states to enact corporation laws of a high standard.

2. The size of many corporations and the tremendous economic power which they have throughout the entire nation makes advisable their incorporation under the federal government. The national government alone has the right to charter these corporations for no state should act as the representative of the people of all the forty-eight states.

3. The chartering of corporations under one law interpreted by one set of courts would provide a uniformity which would simplify legal questions for persons dealing with corporations, prevent some unnecessary litigation, remove many state-erected barriers to foreign corporations, and in general facilitate commerce.

4. Voluntary federal incorporation probably would not bring about uniformity and would permit continuation of competition among the states.

5. Compulsory or voluntary federal licensing seems less desirable than incorporation because the double jurisdiction of the federal and state governments would open the way for conflicts and would be less likely to result in that uniformity of administration which would facilitate commerce.

An examination of a number of court cases on interstate commerce and of lawyers' published opinions on the subject appears to support the view that compulsory federal incorporation of general business corporations engaged in interstate and foreign commerce probably would be held to be constitutional.

If a compulsory federal incorporation law were enacted, it seems advisable to have it cover only the larger corporations in interstate and foreign commerce, especially at the outset. A reasonable plan would be to take as the basis for determin-

ing whether a corporation should be subject to federal incorporation its total assets, total sales, and number of employees. If a given corporation exceeded a certain minimum figure on any one of these three bases, it would be made subject to the federal law.

The changed character of corporations requires a re-examination of the role that accounting should play because it can be a valuable technique for the better control of corporations in the public interest. A federal incorporation law could more nearly achieve this ideal than a state law because the enactment of the state laws has been overshadowed by the thought that if the statutes were too severe in the opinion of incorporators they would go to other states which were more obliging. A number of the federal incorporation bills of the past went too far in the other direction. The accounting provisions of a federal incorporation law should attempt to afford reasonable protection to judicious creditors and security purchasers, should tend to assure continuity of employment to those already employed, and yet offer enough incentive to encourage entrepreneurs to enter areas where they are needed to raise the standard of living and avoid threats of near-monopoly. Most of the bills introduced in Congress on federal incorporation and federal licensing dealt with general business corporations and therefore no consideration is given here to the special accounting problems of banks, investment trusts, insurance companies, railroads, public utilities, and other specialized fields which, for the most part, have been under closer governmental control than the general business corporation.

It would be a relatively simple matter to set up standards which would give a strong measure of protection to some one group at the expense of another. For example, in order to provide an extra cushion of safety to creditors a corporation might be required to build earned surplus up to fifty percent of its capital stock and pay no dividends which would reduce the surplus below this figure. The adoption of such a regulation would probably save creditors from losses in certain instances, but its effect on other groups would be undesirable.

The denial to the corporation of the right to pay dividends on preferred stock for long periods under such a provision would make it difficult to raise funds through the sale of preferred stock, and in many instances would result in the issue of bonds. Since failure to pay bond interest may force a concern into receivership, the excessive use of bonds gives a brittleness to the economic structure which is less desirable than the resilience afforded by preferred stock which gives a better chance to ride out economic storms. Such a limitation on dividends would also tend unduly to discourage the sale of common stock. This would be an unhealthy development because the adventuring of risk capital is essential to the health of a capitalistic economy. The accounting provisions of a corporation law therefore must be weighed carefully for their effect upon society as a whole and not upon any one group.

The draftsman of a corporation law including accounting provisions has to steer his course between the Scylla of vagueness and inadequate regulation and the Charybdis of overly restrictive supervision which displaces individual judgment and throttles progress. If the standards established in the incorporation act are not clear, loopholes are left for those who wish to evade the law and it also may be difficult for conscientious business men to determine what they may do in certain instances without taking the matter to court. On the other hand, there is the danger of prescribing too detailed rules which would tend to have the effect of freezing present practice into law and of discouraging further progress in accounting. This would be especially undesirable in a field like accounting where many advances have been made in the past few decades and which is still in an evolutionary state.

Capital Stock

Net worth is one of the most important areas in which accounting standards should be considered in a federal incorporation law. There is involved here a distinction between capital on the one hand and earnings or other portions of

net corporate investment available for distribution on the other. This is a field which lends itself to uniform treatment to a greater degree than others because corporations which operate in different industries and have wide variations in their accounting systems and cost computations have a much greater common interest in the problems of selling stock, creating various types of surplus, paying dividends, and the like. Not only has net worth been affected by overvaluation of capital stock and of assets but entry of the figures on the books has in turn resulted in the overstatement of depreciation and depletion and has largely been responsible for the problem of donated surplus. A federal incorporation law therefore should require that property or services given to a corporation in exchange for its stock be appraised by independent experts or by government appraisers and that stock at market value be issued only up to this amount.

Closely related to the above statutory provision is the need for a restriction on the power of directors to credit arbitrarily to some form of surplus a large part of the consideration received from the sale of capital stock. This practice repudiates the concept of capital stock as a margin of protection provided by the stockholders for creditors. It seems advisable to require that the following amounts be credited to the capital stock account:

1. At least the par value or stated value (for no par stock) of shares with such values when they are sold at or above these amounts.

2. For no par without stated value:
   a. At least two-thirds of the consideration received, and preferably four-fifths or more.
   b. Directors should be required to indicate before the sale the amount or percentage to be considered as capital.

3. For either par or no par, at least the amount of the preference which the stock has in involuntary liquidation and the highest price at which it may be redeemed at the stockholders' option.

4. In all cases the expenses of selling the stock may

be considered as a reduction of the consideration received.

Surplus

A federal incorporation law should require that the various elements of surplus be clearly enough labeled so that, with the aid of footnotes perhaps, the readers of a balance sheet will be able to determine what may be done with each portion of it. The terminology now applied to subdivisions of surplus does not fulfill this requirement, except where it is accompanied by explanations. Much of the difficulty arises from the fact that the economic capital of a corporation in many cases is not the same as its legal capital. (The economic capital is equal to the legal capital plus the excess of stockholders' contributions over legal capital.)

One subdivision of surplus, which might be labeled returnable capital, should include paid-in surplus, assessments on stockholders, reduction surplus, premium on redemption of preferred stock, gains and losses on treasury stock retired or resold, gifts other than stock, and earned surplus carried forward in a merger or consolidation. All of these items are essentially similar for they represent adjustments of capital and should be kept separate from accumulated earnings. It seems unnecessary and needlessly confusing to attempt to show each of these items in a separate account on a published balance sheet.

It should be permissible to charge to this returnable capital account the selling expense on stock and the redemption premium on preferred stock (although it would be preferable to charge the latter to earned surplus since it is, in a sense, a payment in lieu of future dividends), and dividends on preferred stock when there is no earned surplus. The charging of unamortized discount and redemption premium on bonds to this account is undesirable for these items are a part of interest expense. It seems desirable to prohibit the absorption of operating losses into returnable capital because where this is done the earned surplus no longer presents a true record of the earnings of the company and it may lead to the declaration of dividends on common stock from the

stockholders' contribution. It is especially undesirable for the law to permit this practice and at the same time to prohibit the payment of dividends from returnable capital, as it already does in some states, since dividends declared from earnings accumulated subsequent to the charging of losses to this portion of contributed capital are actually declared from the returnable capital itself. When existing together, two such provisions permit the payment of dividends from returnable capital in the case of companies which have incurred losses and deny this right to corporations which have operated at a profit. A proper law would not take the illogical position of insisting upon greater protection for the creditors of a profitable corporation than for those of one which incurs losses.

The reduction of capital stock by the transfer of a portion to returnable capital represents an important readjustment of the stockholders' contribution and should require the approval of two-thirds of each class of stock and formal notification to the government. The capital stock account should not be reduced below an amount equal to the distribution preferences of all shares having such preference or below the highest price at which the stock may be redeemed at the stockholders' option, for all shares which will remain outstanding after the reduction.

So-called appraisal or revaluation surplus is really a reserve for revaluation. As in the case of returnable capital, operating losses should not be charged to appraisal surplus for this distorts the record of a company's earnings and may lead to the declaration of dividends from capital.

In dealing with the accumulated earnings section of the balance sheet, it would be unwise for the law to go into detail as to how each item entering into the calculation of net income should be handled since there are many variations from one industry to another and the accounting profession is constantly improving its procedures. The law need only require that the income for each period be calculated in accordance with generally approved accounting methods.

Treasury Stock

The purchase, handling, and sale of treasury stock is another area in which a federal incorporation law should establish standards to prevent improper disbursement of assets and misstatement of earnings. Since the purchase of treasury stock is not a regular operation of business it should not be permitted except where the financial position of the company is strong. The law therefore should make some restrictions such as the prohibition of the purchase of the company's own stock which would reduce the book value of net assets to less than one and a quarter times its liabilities including preferred stock, or which would reduce the current ratio to less than two to one.

Some restriction based on the equity side of the balance sheet should also be placed on the purchase of treasury shares. Since preferred stock is closely akin to a liability, its redemption might be considered similar to the cancellation of a liability and might be done without regard to the amount of earned surplus. Shares without preference, however, should be redeemed only to the extent of the amount of earned surplus on hand. Where this is the only class of stock outstanding, there seems little objection to purchasing it up to the amount of returnable capital as well as of earned surplus. If there is no earned surplus it means all the assets of the business represent the capital advanced by creditors and stockholders. When a corporation buys its own stock at such a time it is using up assets of particular interest to some creditor or stockholder to buy back stock from another stockholder. The purchase of stock under these conditions is unfair since the safety margin is zero and losses in the near future may wipe out part of the equity of remaining stockholders. Accumulated earnings in an amount equal to the cost of the shares purchased should be earmarked and considered available only for the absorption of losses. It would be proper to permit the purchase of stock without preference from returnable capital for a few stated miscellaneous purposes such as stock taken to compromise a debt in good faith, to eliminate fractional shares, or to pay off dissenting shareholders in event of a merger of corporations.

After treasury stock has been purchased there is the problem of how it should be carried. Since the purchase of the company's own stock represents a reduction in the equity of stockholders and limits further purchases of treasury stock and the payment of dividends, it is advisable to require the cost of treasury shares to be deducted either from earned surplus or from the total of capital stock, returnable capital, and earned surplus, with the cost of the treasury shares shown parenthetically alongside the earned surplus. The purchase of treasury stock is an uncompleted transaction, and therefore no gain or loss should be recognized until the stock has been resold or retired. If preferred stock has been redeemed out of assets represented by stated capital, it should be shown as unissued stock and handled as such thereafter. The receipt of donated treasury shares should be recorded by memorandum entry only.

The gain or loss on the resale or retirement of treasury stock represents an adjustment of the capital originally contributed to the company and therefore should be entered in the returnable capital account. If the loss exceeds the amount in this account, the excess should be charged to accumulated earnings. It would be unsound to permit the paying out of all earnings as dividends while the capital of the company was being dissipated by losses on treasury stock transactions. At the time of retirement or resale of treasury shares the earned surplus which was earmarked at the time of purchase should again be made free. Retirement of shares should require approval of at least a majority of the stockholders and formal notification to the government since this represents a permanent reduction in the capital of the company.

Dividends

Dividends should be made only from accumulated earnings. If there is a cumulative deficit, this means that the capital contribution has been reduced and this should preferably be repaired from subsequent earnings before dividends are declared on common stock. In the case of preferred stock, in order to give this special type of liability a greater con-

tinuity of dividends it should be permissible in the case of a cumulative deficit to use a portion of current earnings, say three-fifths, for dividends and if this is not sufficient, to draw upon returnable capital for such dividends. Dividends from returnable capital should be allowed only to the extent that the amount therein exceeds the deficit for otherwise the dividend would eat into the legal capital. Dividends paid when there is a deficit should be accompanied by a notice of their source to the recipients so that they may know that they are not from accumulated earnings.

To set up in advance a buffer against losses and to prevent, to some extent, an impairment of capital it should be required that a certain amount of accumulated earnings, perhaps equal to five or ten percent of the capital stock outstanding, be reserved as unavailable for dividends on common stock. A better basis for the reserve, however, would be the total of fixed and current liabilities outstanding. The purpose of the reserve is to protect the creditors and therefore the size of the reserve should fluctuate with the amount of the creditor interest in the corporation. A still more scientific refinement might be to require that enough earnings be retained to maintain the net worth at a predetermined percentage of the corporation's total debt. Dividends on preferred stock might be paid from this safety margin if necessary in order that dividend continuity be maintained.

Statutory restrictions on dividends should take into account the current financial condition. This is necessary in addition to the profits test because a company with large accumulated earnings might have them tied up in fixed assets and be in a weak current position. No dividend should be declared which will reduce the current ratio below a certain point, say two to one. The profits test and current ratio test are two separate lines of defense and each has its value.

Although many states have restrictions to prevent directors from paying out too much in dividends, only a few even attempt to prevent the paying of too little. It seems to this writer advisable that corporations be permitted to retain in earned surplus only an amount equal to some set

percentage of outstanding securities, and that any excess above this amount must be disposed of within one year from the close of the fiscal year. The two principal reasons for this are, (1) the individual stockholder should have the right to decide what to do with his share of accumulated earnings, (2) the directors of a corporation which has made profits should not be the sole arbiters of whether these funds are to be reinvested in their own corporation or elsewhere.

One of the most important phases of a stockholder's relationship to his corporation is indicated by the amount of dividends he receives, yet he has in fact very little to say about whether the company's earnings should be paid out or retained in the business. A realistic examination of the large American corporations of today would show that the directors of these concerns are very largely self-perpetuating groups over whom the stockholders have practically no real control. Further, many of these directors are officers of the corporation. The interests of management and stockholders do not always coincide on some important matters. Management is inclined to risk the corporation's accumulated earnings in further expansion because this generally has been considered the road to bigger salaries and bonuses and greater prestige. On the other hand, stockholders are interested in sizeable dividends and a reasonable degree of security; to them the size of the corporation is relatively unimportant. The votes of management-directors may tend to come under the control of some dominant person such as the chairman of the board or president of the company who has the power to discharge them from their positions. Such considerations in the minds of these directors may all too easily supersede their duty to serve the interests of the many stockholders with whom they have little or no contact. Even if stockholders could influence directors on the matter of dividends directly, the individual stockholder still would not control his share of the earnings for if fifty-one percent voted to retain the earnings, the other forty-nine percent would be forced to abide by the decision. It is not a satisfactory answer to say that the dissatisfied stockholder may sell his stock because the market price of the

stock is influenced by a number of factors only one of which is the earnings of the company. The price at which he sells may therefore deprive him of his share of the corporation's retained earnings.

The second argument in favor of forced payment of earnings involves the question of social control. The self-perpetuating directors of a corporation should not be the sole judges of whether they, rather than those in some other enterprise, are entitled to use the accumulated earnings of their company for purposes of expansion. The retention of earnings by one company automatically denies the use of them to other entrepreneurs. Under the proposal made herein the greater part of most corporate earnings would have to be paid out in dividends and to finance expansion each corporation would have to go to the capital market and compete with other enterprises seeking funds. It should be noted that this proposal does not place any arbitrary limit on the size to which a corporation may grow. It simply transfers the decision as to when and how much a corporation may expand from the directors to the investing public.

Reports and Audits

An important duty of a quasi-public institution like a large corporation engaged in interstate commerce is the publication of certain essential information about its activities. A federal incorporation law therefore should establish standards of performance in this area and require that accounting statements be prepared and issued to such parties as may be deemed to have a right thereto and in a form and at intervals which are in accordance with sound accounting principles and practice. The law might add that this would ordinarily be construed to mean at least an annual balance sheet, profit and loss statement, and analysis of surplus. In order that reports shall be reliable, the law should specify that the controller of the corporation or some other designated individual be responsible for all accounting reports issued and that the company's records be examined by independent public accountants.

Thus, in return for the special privilege of engaging in interstate and foreign commerce in corporate form, entrepreneurs should be required in the public interest to accept accounting controls which were designed to effect certain controls over their financial activities. In the formulation of these accounting standards to be included in the law, the draftsman must seek the middle ground between that which is too vague and that which is too detailed. The standards should not be so general as to require a continuing stream of costly court cases to determine just what should be done, nor should they establish a code so detailed and narrow that there is no room left for evolutionary improvement generated by unfettered minds constantly seeking better solutions to the problems of business.

VITA

Robert Irvine Dickey was born on April 1, 1909 in New York, New York. He attended the public schools of New York City and graduated from Boys' High School, Brooklyn, in 1926. In 1930 he received the Bachelor of Science degree in Economics from Wesleyan University, Connecticut, with honors in general scholarship. From September 1930 to September 1938 he worked as an accountant on a wide variety of assignments for the General Electric Company at Schenectady, N.Y., New York City, and Bridgeport, Connecticut. In addition to accounting, his duties included some personnel and general administrative work, and membership on the Radio Manufacturing Committee of the company. During the first three years of his employment he completed, with honor grades, the full curriculum in accountancy and business law given in the evening classes of the Business Training Course of the General Electric Company. In September 1934 he was appointed an accountancy instructor in the General Electric Business Training Course at Schenectady, N.Y. For the three years 1935 to 1938 he served as an accountancy instructor in the company's evening classes at Bridgeport, Connecticut. For the spring semester of 1938 he also taught evening classes in accountancy in the Junior College of Connecticut in Bridgeport. In September 1938 he entered the Graduate School of the University of Illinois to prepare for college teaching and in August 1939 received the degree of Master of Science in Accountancy. In June 1940 he was awarded first prize in a national essay contest for graduate students on an accounting subject conducted by the Controllers' Institute of America. He has published the following magazine articles: "Protection for the Investor in Municipal Bonds" in the *United States Investor* of April 27, 1940; "Relations between Controllers and Public Accountants" in *The Controller* of June 1940 (republished in *The Accountants Digest* of September 1940) ; and jointly with Professor Lloyd Morey "Accounting and Local Government Borrowing" in *Opinion and Comment* of August 6, 1940. In September 1940 he was appointed assistant in accountancy at the University of Illinois and in September 1941 instructor in accountancy.